

FINAL REPORT ON LESSONS LEARNED

Prepared for

Prepared by

James S. McCullough
Research Triangle Institute

Stefan Ivanov
Club Ekonomica 2000

East European Regional Housing Sector Assistance Project
Project 180-0034
U.S. Agency for International Development, ENI/EEUD/UDH
Contract No. EPE-C-00-95-001100-00, RFS No. 219



THE URBAN INSTITUTE
2100 M Street, NW
Washington, DC 20037
(202) 833-7200
www.urban.org

November 1998
Revised May 1999

UI Project 6610-219 Task 4.1

TABLE OF CONTENTS

LOCAL TAX SYSTEMS	1
Property Tax Yield and Performance	1
Other Local Taxes	3
LOCAL TAX ADMINISTRATION	5
Summary of Recommendations on Local Taxes	6
LOCAL FEES AND CHARGES	7
Garbage Collection Fees	7
Revising Tax and Fee Schedules	8
Summary of Recommendations on Local Fees and Charges	10
CITIZEN PARTICIPATION	11
Development of Strategy for Communication and Citizen Participation	12
Development of a Municipal Customer Service Center	13

FINAL REPORT ON LESSONS LEARNED

The Plovdiv Project has made a number of useful findings for both policy changes and for strengthening capacity at the local level. In addition, the Project employed a number of analytical techniques that can serve as models for doing this type of analysis elsewhere. The following paragraphs summarize the findings in terms of national policy prescriptions, local capacity building and methodological recommendations.

LOCAL TAX SYSTEMS

The Law on Local Taxes and Fees which went into effect in 1998 has attempted to increase the yield of the local taxes and fees. This has been successful up to a point but local taxes and fees still account for a quite small share of total local budgets. Although we will not know the final results for revenue collection until after the 1998 calendar year closes, it would appear that as share of the Plovdiv municipal budget, local taxes (excluding shared national taxes) have increased from 1.9 percent in 1997 to 4.75 percent of the total budget in 1998. Since the total budget has increased from BGL 44.4 billion in 1997 to BGL 72.8 billion in 1998, the yield of the local taxes has actually increased about fourfold in current leva. However, this trend of increasing local taxes will not continue unless the Law is amended to raise the tax rates since the tax rates are fixed by Parliament in the Law.

Property Tax Yield and Performance

The Plovdiv Project devoted considerable attention to the operations of the local property tax, particularly as it had been revamped in the Law on Local Taxes and Fees. The revamping included a re-registration of all real property during the year and the imposition of a new valuation schedule and higher tax rates across the country. However, the system was fundamentally unchanged in terms of overall structure and the basis for taxation - i.e., tax is based on a schedule of values keyed to area of buildings and land¹.

The main finding with respect to the performance of the property tax is that the tax listings are relatively complete with approximately 94 percent of the housing and business premises listed, based on a sample survey conducted by the Plovdiv Project team in conjunction with the Regional Tax Office. The sample survey did find that the main deficit with the current system of discovery of tax objects is that improvements to property were occasionally missing - for example, building additions and garages, or conversions from residential to business usage. Even so, the sample survey concluded that 91.2 percent of total taxable objects (by value) were on the property tax rolls.

Collection efficiency of the property tax is also quite high in Plovdiv. In 1997, the collection was 95 percent. Within the first six weeks of the issuance of 1998 tax notices in

¹ The valuation schedule has differentiated categories base on type and age of buildings and zones of the cities as well as indexes for citie ring sizes and economic condition.

August, fully 70 percent of the property owners had already paid in the municipality according to the RTO. In our sample district, almost 80 percent of households interviewed reported that they had paid.

The main problem with the property tax is that the tax rates are so low that the yield is quite low. Furthermore, this low yield is further reduced by a number of categorical exemptions that reduce the total yield by about 33 percent. The per capita yield of the property tax in Plovdiv will be about BGL 3,500 per person for 1998 or about US \$2.00. There is considerable debate over how high the tax rates could be raised given the low level of household income but clearly there is some room for increasing our sample survey found less than one third of the households interviewed thought that the current rates were high.

The Plovdiv Project team examined the question of whether the property tax should be turned over to municipal control. The findings are that:

- . The municipal government does not now have the experience or systems to manage a large scale tax records system required by the property tax in Plovdiv. The property tax system in Plovdiv has a total tax roll of about 118,000 premises with 171,637 property owners (joint ownership requires separate tax liability and individual tracking of payments).
- . The tax yield is so low that it could not be justified on strictly financial terms to transfer the system - it would simply cost more to effect the transfer and the yield would possibly decline given that the collection efficiency is already quite high.

On the other hand, there are good arguments that the property tax should be made a principal local tax source under the direct control of the local governments. For that to happen, tax rates will have to rise considerably and local governments must acquire the capacity to manage a large scale tax system. In addition, there is growing sentiment among local governments that different localities be given the option to decide which tax sources should become their main sources and some control over the rates. This is particularly the case with the property tax where the larger cities have expressed an interest in being allowed to make the property tax a larger part of local revenues².

Once it has been decided to allow the property tax to become a significant source of local revenue, another set of decisions will have to be made about whether the tax base should be changed to an *ad valorem* base, i.e., a system based on market value of the property. Such a change is certainly not justified unless rates rise substantially and the

²See findings of the Policy Forum on Fiscal Decentralization in Bulgaria sponsored by the Foundation for Local Government Reform, September 3-4, 1998 in Sofia.

system of categorical exemptions is revamped and reduced. Furthermore, there is still some debate as to whether the property market is mature enough in Bulgaria to provide a sound basis for a market value basis³. These considerations are well beyond the scope of the current study but do deserve analysis if and when a decision is made to increase the importance of the property tax as a local revenue source.

To overcome the lack of local capacity to manage a large tax records system required by the property tax, the Plovdiv Project team has designed a follow-up effort which assists the municipality in developing a management information system (MIS) for local taxes and fees. The MIS links together the municipal departments dealing with taxes and fees with the Regional Tax Office and several other agencies that have data relevant to local tax and fee liability. The MIS will help tie together the information on tax and fee bases across the different offices and, at the same time, help the municipality to build the capacity to manage larger scale tax and fee collection systems.

In conducting the sample survey of property tax performance, the Plovdiv Project team developed a cost-effective sample survey (inspection) approach which could be used in other cities to identify properties not on the tax rolls as well as errors in the tax listings. The sample inspection covered an area of the city which contained slightly less than 1 percent of the total households and cost BGL 1.1 million to carry out.

The team has estimated that a set of 10 similar sample inspections to that conducted under the project would cost approximately BGL 6.5 million and should produce a minimum of BGL 45 million in additional tax revenues alone for Plovdiv. In addition, since the garbage collection fee for households is also based on the property tax base, any increase in property valuation results in a higher yield of the garbage fee. In the case of Plovdiv, the garbage fee has been set for 1998 to yield about 2.5 times the actual property tax for households, so the potential impact of the proposed sample inspection program should achieve a payoff ratio of more than one to twenty, i.e., for every one leva spent on inspections, the increase in property tax and garbage fee revenue combined would be twenty leva. Of course, any increase in overall tax rates will multiply the yield of the sample inspection program even further without raising the costs.

Other Local Taxes

The other local taxes include the vehicle tax, inheritance tax (mainly concerned with property transfers) and the gift tax (also mainly concerned with property transfers). These taxes contribute the following amounts to the Plovdiv revenue budget in 1998:

³The high level of individual home ownership in Bulgaria - estimated at between 90 percent and 95 percent - argues that conditions for a property market exist but the financial turmoil of the last several years and the lack of housing credit have impeded the functioning of the housing market.

- . Gift and transfer tax 1.54 percent
- . Vehicle tax 1.40 percent
- . Inheritance tax 0.09 percent

The vehicle tax is the second local tax, after the property tax, where a rise in rates is warranted. Currently rates are modest, although the law on Taxes and Fees did significantly increase them for 1998. The yield of the tax is expected to reach about BGL 1.2 billion in 1998, up from BGL 140 million in 1997. Currently, there are estimated to be about 90,000 vehicles in Plovdiv and the rate of ownership is expected to rise rapidly with the economic recovery. The vehicle tax can become a sizeable and buoyant revenue source if the rates are allowed to move upward as the size of the vehicle population increases. Since vehicle ownership is closely associated with income and wealth, increasing taxes on vehicle ownership is warranted, particularly in a city like Plovdiv where traffic congestion and parking present growing problems.

In addition to the taxes designated as local, a patent tax was added this year as part of the national income tax code to ensure that small scale businesses were captured in the tax net. This tax is shared 50 percent with municipalities in the same manner as the personal income tax but it is considered by many local officials to be a local tax⁴. Indeed, there is considerable sentiment within the Ministry of Finance and the Regional Tax Offices to transfer this to the municipalities as a strictly local tax.

The first year of operation of the patent tax has encountered some problems in that the national government revised two of the tax rates on occupations which has caused some patent tax payers to delay payment in the hope that there will be further rate changes. This has caused the yield of the patent to be running well below the expected yield at the beginning of the year. At present, the RTO estimates that the yield of the Patent Tax will be only 60 percent of the earlier estimate. This lower than expected yield has been caused partly by the aforementioned rate changes, the slowness in payment and the lower than expected level of tax registrants.

⁴The National Association of Municipalities lobbied hard to have the patent declared a local rather than a shared tax; municipalities have considerable data on local business activities that would make them a logical administrator of the tax.

The patent tax was expected to yield about 3.75 percent of the local revenues, or about BGL 3 billion, at the start of 1998. The yield is now expected to be about BGL 1.8 billion. Clearly the experience of the patent should be carefully examined at the end of the year to determine whether the business categories need to be changed, the rates altered and to examine the actual experience with collection efficiency. At a minimum, provision needs to be made to keep the rates buoyant, i.e., current with inflation and business activity, since they are now fixed in national legislation. In addition, a decision will have to be made about converting the patent to a strictly local tax which at a minimum will double the yield for the municipalities (since it is currently treated as a shared income tax with only 50 percent transferred to the municipality).

Were the patent tax transferred to a local tax, in Plovdiv it would double the total yield of local taxes at once, assuming the collection rate could be improved. In addition, since the number of tax objects is relatively small (about twelve thousand in Plovdiv), the creation and maintenance of the tax records system would not be nearly as great, particularly as compared to the property tax and vehicle taxes. Furthermore, since the municipality already licenses most of the patent tax payers, it is the logical place to administer this tax.

LOCAL TAX ADMINISTRATION

It has been noted above that municipalities do not yet have the capacity to directly administer the local taxes, particularly the property tax which requires the largest tax records system. At the same time, the current low yield of local taxes also suggests that the cost of transferring responsibility from the Regional Tax Office to the municipality are hard to justify on strictly a cost-benefit basis. That is, the cost of the administrative shift will cost more than the revenue increase, which may in fact decline since the RTO collection efficiency on local taxes is quite high, at least in Plovdiv.

There is a desirability to transfer authority to municipalities for local tax administration on the part of some municipalities and on the part of some RTO staff. There is also good theoretical justification to do this as well as impetus from the norms established by the European Union. However, it is in no one's interest to transfer authority until the municipalities are prepared to handle it competently. Failure will hurt municipalities and their citizens. Failure will set back the cause of fiscal decentralization and the growing local self government movement. Therefore, we propose the transfer of authority for local tax administration be done on a pilot basis and, to the extent possible, by local option. This means that municipalities would apply for entry into the pilot program and criteria would have to be established to determine when municipalities are prepared to handle local tax administration. In addition, the pilot program should be linked to progress on increasing

local tax rates.

Summary of Recommendations on Local Taxes

National Policy Level

- . Increase rates for property and vehicle taxes
- . Revise, and reduce, property tax exemptions
- . Permit local option for municipalities to select tax bases as major sources
- . Transfer Patent Tax to local tax base
- . Set criteria for transfer of local tax administration on local option basis
- . Study results of Patent Tax for 1998 and determine changes in base and rates

Local Capacity Building Level

- . Municipalities need to acquire systems for managing local taxes including tax rate setting, collection and enforcement
- . Municipalities need to improve real property cadastre as base for local property tax administration
- . Municipalities need to acquire experience in tax base identification and large scale tax records management that requires close cooperation with RTO and selected other agencies
- . Municipalities need to demonstrate sufficient level of expertise before local tax administration can be transferred

Methodological Level

The Plovdiv Project has produced the following:

- . Methodology in property tax inspections to determine existing compliance and stimulate better tax registration
- . Methodology in information exchange to strengthen the Patent Tax yield
- . Methodology to design an MIS for improving tax base information and to build capacity within municipality for tax administration
- . Methodology for assessing cost-benefits of transferring tax administration from RTO to municipality
- . Methodology for assessing the impact of local tax burden on household budgets

LOCAL FEES AND CHARGES

The Law on Local Taxes and Fees raised the allowable amounts charged for municipal fees and charges. However, the biggest single impact has occurred in the garbage collection fee which has been handed over completely to local discretion in terms of setting the rate as percentage on property tax valuation.⁵

In Plovdiv, the rates for the garbage fee were raised approximately five fold on households and the total yield of this fee has gone from BGL 534 million in 1997 to a target of BGL 3.5 billion in 1998. This increase relies heavily on households which are paying two thirds of the total fees while enterprises pay the other one third. Based on the cost analysis of the garbage service conducted by the Plovdiv Project team, this involves a significant cross-subsidy from households to businesses and should be corrected in future years.

The garbage fee is expected to account for approximately 60-65 percent of the total fees and charges collected in Plovdiv for 1998. Market usage charges should comprise another 20 percent based on a much stronger yield over the first eight months of 1998 than expected. The other significant fee is the one for Kindergarten usage which should yield about 10 percent of total fees and charges. The total yield of fees and charges will show an increase over 1997 of about 150 percent, a figure which could go even higher if the strong collection trends hold up.

Overall, fees and charges will comprise about 7 percent of total local revenues in 1998 which is an increase over the 5 percent share in 1997.

Garbage Collection Fees

Since the garbage fee is by far the most important local fee/charge and was turned over to local control in 1998 we have concentrated on this element in the Project. We conducted a separate exercise on the garbage collection fees to determine how well the fee was meeting its cost recovery mandate and how well the fee is structured. The fee is comprised of two main categories: fee for households and fee for enterprises. The household fee is based on a levy on the property valuation, currently set at 0.15 percent of valuation based on the new 1998 revaluations. Businesses are given an option of paying a rate based on property tax valuation (0.6 percent of valuation) or on a per container charge. Most businesses opt for the container charge since it is cheaper - and in fact is set too low to recovery the cost of the service.

⁵The municipality has discretion in determining the fee structure for enterprises separately and for setting the fee for households as a percentage of the property valuation. The municipality cannot establish a different basis for the household fee without a municipality referendum.

The Project analysis of the cost of service revealed that there are substantial variations across the six districts of Plovdiv in costs of collection services, which are currently operated under 3 year contracts with private companies and the Plovdiv municipal enterprise. Furthermore, the cost of land filling the collected waste will start to rise substantially in 1999 when the costs of a new landfill are shifted to the city.

The large increase in the garbage fees for 1998 enable the city now to recover about 70 percent of the cost of the service. The finding that households are now subsidizing enterprises should be addressed in setting the fees for 1999, primarily by increasing the per-container charges to businesses.

The municipality has been considering a change from the property-based fee to one based on a per capita charge. This is seen as more equitable by the local leaders since they receive many complaints particularly from elderly homeowners who think they are charged disproportionately for the service they receive. However, the analysis by the Plovdiv Project team has indicated that a per capita fee would discriminate against the larger and poorer households which produce relatively less waste on a per capita basis. Since the current system is efficient from a collection standpoint, the municipality should consider not changing to a per-capita basis but allow a fee reduction based on income status. In such a system, pensioner households could apply for a deduction but otherwise the system would remain as is. Any such change to the current system would require either a change in the Law on Taxes and Fees or a referendum in the municipality.

There is considerable sentiment from municipalities in general for them to be granted the right to set all local fees and charges based on actual costs of service rather than be constrained by a nationally set schedule of fees and charges. Such a change is apparently permissible under the Constitution. The proposed pilot MIS in Plovdiv will permit the municipal government both to improve its database on fees and charges and to improve its cost analysis to better set fees.

Revising Tax and Fee Schedules

At present local taxes and fees are governed by schedules contained in national legislation. The schedules are fixed and can only be changed by new legislation. This will keep the yield of these revenues from growing buoyantly since they can only grow as fast as new units are added to the tax and fee rolls.

There are several measures that could fix this problem. The least likely is a change in the Constitution to remove the requirement that all tax rates be set in legislation. The other options include:

- . Allowing fees and charges to set by local option; and

- . Adopting a mechanism to make changes in local tax rates more convenient.

The mechanism to make changes to tax rates more convenient is to revise the Law on Taxes and Fees to place all tax schedules in a separate chapter which is intended to be revised on an annual, or at most bi-annual, basis. The Law could even have default clause which called for all specified rates to rise as a function of inflation or other index in the event that the Law were not amended on schedule.

By building this process for updating tax rates into the Law, we would avoid the inevitable struggle of revamping rates legislatively and the near certain fact that local tax rates will not be raised as needed. Experience around the world shows that when local tax rates are fixed in national legislation, they inevitably fall behind inflation rates and become increasingly resistant to being raised.

Summary of Recommendations on Local Fees and Charges

National Policy Level

Allow municipal governments to set fees and charges
provide comparative data on fee and charge experience across municipalities
Establish mechanism in Law on Local Taxes and Fees to permit frequent
updating of rates - especially for local taxes and in case municipal fee/charge
rates are not transferred to local discretion

Local Municipal Level

Set garbage fee rates for enterprises to recover all costs and remove cross-
subsidy
Examine system for deductions for pensioner households
Maintain property based fee
Implement MIS to improve cost analysis and fee/charge setting

Methodological Level

The Plovdiv Project has produced the following:

Methodology for analyzing costs of garbage services and assessing cost
recovery from households and enterprises
Management Information System design for linking municipal departments, the
RTO and other agencies that have data relevant to local fees and charges

CITIZEN PARTICIPATION

The Project conducted a set of activities jointly with the Local Government Initiative (LGI) staff working on citizen participation but tailored to the Project scope specifically addressing fiscal decentralization issues in Plovdiv.⁶ The original RFS Scope of Work envisioned several activities that were essentially aimed at improving tax payer compliance and therefore local revenue mobilization.

Initial analysis on tax and rate paying compliance in Plovdiv indicated that payer compliance per se was not a problem since collection rates were generally quite high.⁷ The main obstacle to increasing local tax and fee revenue is the imposition of low rates by the national government as noted above.

At the same time, it became clear from discussions with the Plovdiv municipal administration and local community organizations that the municipal government did not have good information on citizen attitudes toward levels of taxes and fees especially after the rate increases of 1998 nor on their level of satisfaction with municipal services. In particular, a major problem emerged in the complexity of service delivery responsibilities between the central city administration and the districts (rations) this complexity has resulted in poor communication among the different parts of the local government administration and confusion on the part of citizens about how and where to deal with issues of rate paying and service delivery.

The Plovdiv Project and the LGI Community Participation (CP) Team used a two prong approach in addressing the CP issues of fiscal decentralization in Plovdiv:

- . Develop an overall strategy for communication between city administration, district offices and citizens that is both (a) based on sound information about citizen attitudes and demands and (b) inclusive of the major stakeholders - municipal staff, elected officials, Regional Tax Office staff and community NGOs.

⁶ Although Plovdiv is not one of the LGI partner cities, it was agreed between USAID and LGI that the Plovdiv Project would apply the Community Participation approach which is fundamentally similar to the approach suggested in the RFS 219 Scope of Work but differs in several details. For example, the LGI approach does not mandate the creation of a Tax Information Center but rather the establishment of a Customer Service Center which encompasses the former and is tailored to the needs and priorities of each municipality. Secondly, the LGI approach does not automatically mandate the conducting of a public information campaign to increase tax paying compliance as suggested in the RFS. Rather, it encourages the use of citizen survey techniques and local NGOs to develop targeted strategies to improve the responsiveness of local government, a greater understanding of taxpayer concerns and selective interventions to improve revenue generation at the local level.

⁷ See James S. McCullough, Assess the Feasibility and Net Impact of Decentralizing The Administration of Local Taxes Task 2.1 Plovdiv Fiscal Decentralization Project. October 1998.

- . Development of a municipal customer service center that covers tax/fee paying and other issues of municipal service delivery.

Development of Strategy for Communication and Citizen Participation

The first step in the process was to develop and test a survey of citizen attitudes toward local taxes/fees and quality of municipal services as well as a secondary survey of business owners who are required to pay the new patent tax. This latter part of the survey was added when it became clear that collection problems were emerging with the patent tax midway through the year (July 1998).

The survey was conducted by a Bulgarian social research and survey firm in September 1998. The results are contained in a separate report under the Plovdiv Project.⁸ The survey revealed a considerable amount of information on what municipal services are used, their quality as perceived by the citizen-consumers, attitudes toward local taxes and fees and tax/rate paying behavior. The survey focused a good deal on the garbage collection and garbage fee. Notable findings were that customer satisfaction varied greatly among the different districts which in fact use different contractors and spend very different amounts per unit of garbage collected. The survey revealed that the fee for garbage services has been raised high enough in 1998 that the citizenry now consider it to be very high, especially in light of the poorly regarded level of service. This suggests that increasing the fee to full cost recovery especially to incorporate the future costs of the new landfill will be difficult.

The results of the survey were presented to the mayor and city council. The council decided to form a Task Force to improve communications with citizens and among the six districts and main city administration. The Task Force received a follow-up training workshop on Communication and Citizen Participation in January.⁹ Thirty-three elected and appointed city and district government officials produced draft work plans for customer service improvements. They applied the results of the citizen satisfaction survey to begin the design of service improvements that address citizens needs and expectations. They

⁸ See NOEMA Social Research & Marketing, Citizen Satisfaction with Local Government Finance Services October 1998. Task 3.3 Re div Fiscal Decentralization Project. October 1998.

⁹ The workshop had been originally scheduled for November 1998 but was moved at the request of the Plovdiv mayor. Since, it occurred : RFS 219 time period expired, LGI funded the workshop costs. The Youth Center for Education for Democracy, a Plovdiv-based NGO w received USAID support through the Democracy Network, helped plan and deliver the workshop.

agreed the increased knowledge of citizen expectations and of group work techniques learned in the workshop could help them continue service improvement efforts through a change in political leadership.¹⁰

Development of a Municipal Customer Service Center

The Task Force on citizen participation and the mayor also initiated the development of a customer service center as a centralized office in Plovdiv to provide both information on local taxes/fees and municipal services and help citizens resolve problems.

The Plovdiv Project and LGI organized a demonstration of the LGI Customer Service Center road show for the city council, senior municipal staff and NGOs. The road show is a workshop which shows examples of municipal customer service centers from the USA, Poland and two Bulgarian cities where such centers have been created with LGI technical support.

Following the workshop, the mayor has identified a municipal building to be used for the customer service center in downtown Plovdiv and the Task Force has begun planning for its establishment. It is anticipated that the customer service center will help resolve the communication problems among the district offices which will be assisted by the parallel development of the municipal Management Information System whose conceptual design was completed under Task 2.3 of this RFS.¹¹

The development of the municipal Management Information System (MIS) is awaiting clarification from the national Ministry of Finance about the possible transfer of responsibility for local tax and fee collection from the Regional Tax Offices to municipal control. The extent to which certain responsibilities may be transferred will change the requirements of the system. Draft legislation is now circulating within Parliamentary committees about this change (May 1999). However, the municipalities, as represented by the National Association of Municipalities of the Republic of Bulgaria (NAMRB), do not want to assume responsibility for collection without more control over tax and fee setting.¹²

¹⁰ The Plovdiv Mayor announced the day before the workshop that he would not run for re-election in the Fall election.

¹¹ See Scott Herman-Giddings, Improving Information Availability for Municipal Revenue Enhancement Task 2.3 Report, Plovdiv Fiscal Centralization Project. October 1998.

¹² The information in the Task 2.3 Report, which addressed the problems with low tax and fee rates, was presented at the national Policy Forum on Fiscal Decentralization in November 1998 by both the author and the Plovdiv Municipality Director of Finance. The Forum included representatives of the Ministry of Finance and the national Parliament as well as NAMRB and municipal officials.